DOW THEORY LETTERS INC.

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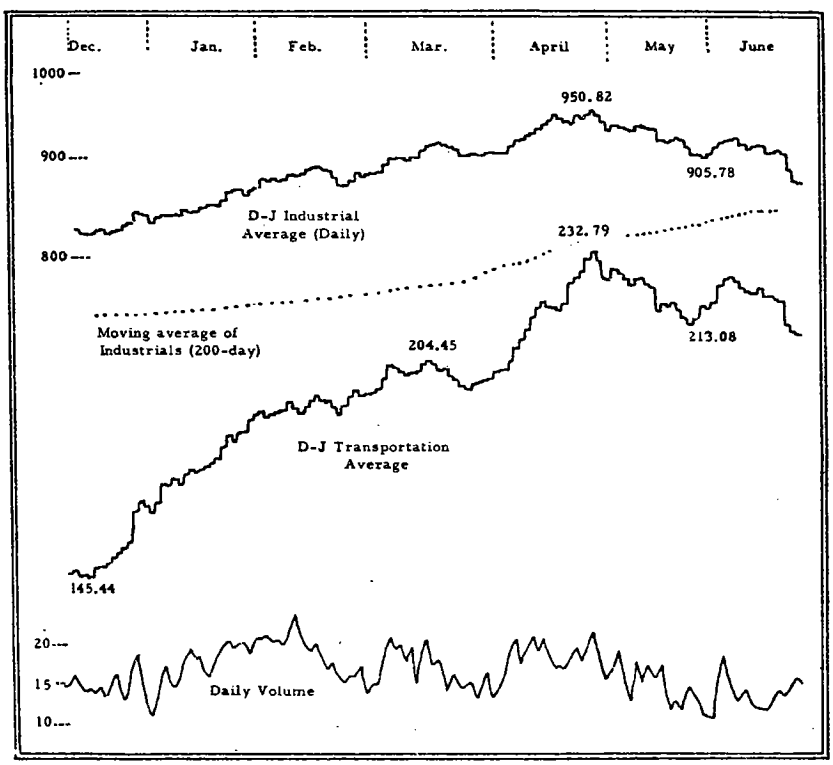
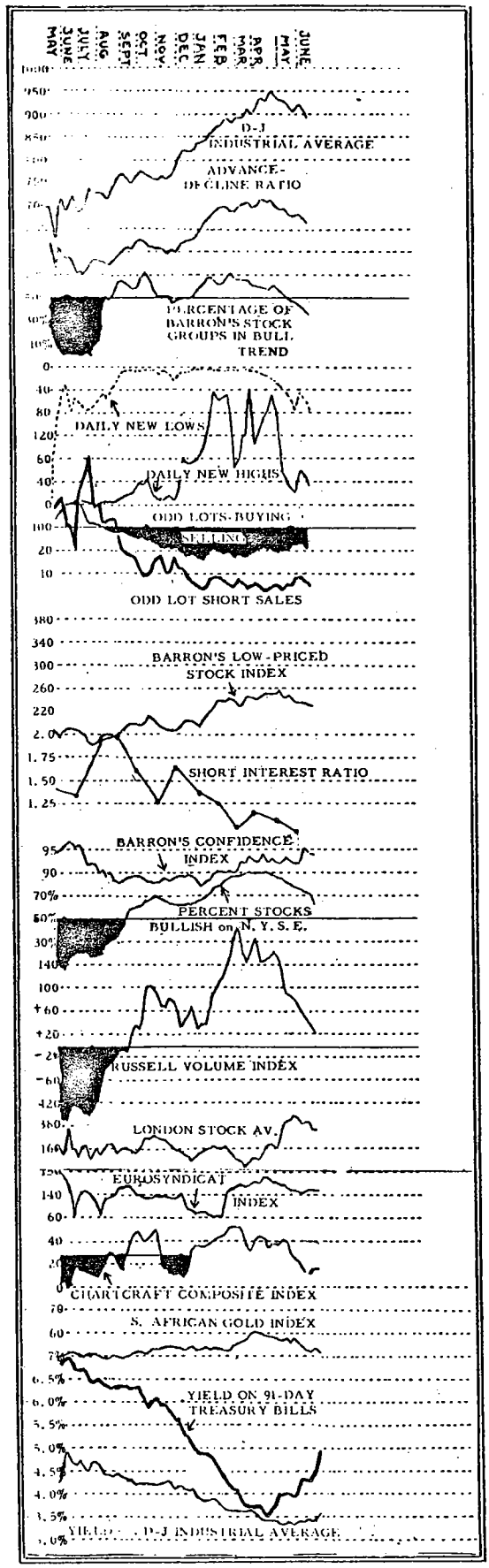
THE MARKET: On April 28 the D-J Industrial and Transportation Averages struck recovery highs of 950.82 and 232.79 respectively. A one month decline carried into late-May, with the two Averages touching lows of 905.78 (Industrials on May 27) and 213.08 (Transports on May 25). From there (see chart below) a one-week rally carried the two Averages towards the highs again, following which a new decline set in. On Friday (June 18) Industrials dropped below their May 27 low in a violent 17-point decline. On Monday (June 21) Transports confirmed by cracking their own May 25 low. Although both days saw better than 1100 declines against less than 300 advances, volume (which was expanding) was not particularly high. Yet on the face of it the Averages have traced out a bearish downward zig-zag or "mini-bear signal".

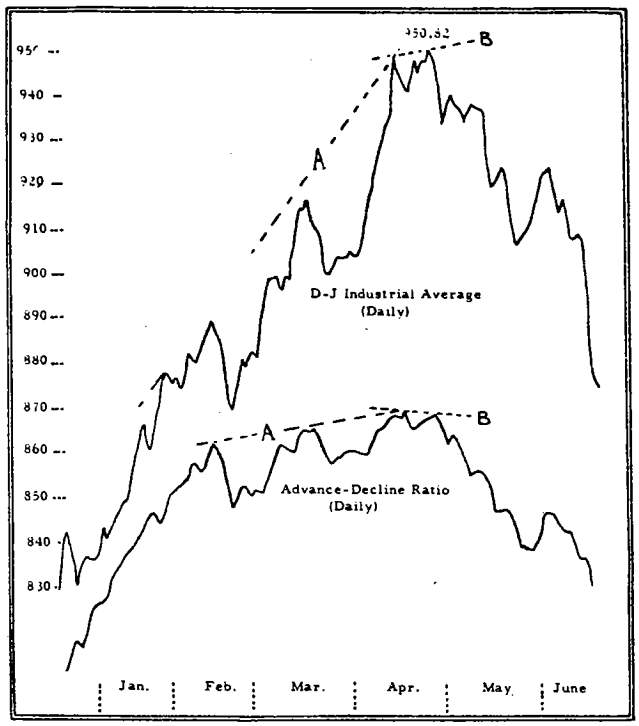
It is too early to tell at this writing whether this is the "shakeout" preparatory to what could be a summer rally or whether the market has further to go on the downside before it halts for some sort of summer rebound. It does not matter much either way. The technical structure of the market has been severely damaged, the advance-decline ratio has been battered badly (see later section), and on June 21 almost a tenth of the issues traded touched new lows.

A number of subscribers have pointed out that a "head-and-shoulders" pattern has just been completed in the Industrials Average, and this is true. In Letter 497 I cautioned about the current widespread almost flagrant use of "indicators", and I want to warn subscribers that I place less credence on short-term and even intermediate indicators at this time than ever before. The big picture is the one to watch, and the big picture is that the second





massive upward correction in this primary bear market has now probably exhausted itself. A summer rally could conceivably take us back to the April high on the Dow again (although I doubt it), and I believe the next major move will be down as the economies of the U.S. and the world slide deeper and deeper into the abyss.



LAG, THEN SAG: Back in Letter 494 I presented my chart of the Percentage of Groups Advancing, and I pointed out that I had received "the first bearish signal on this Index since March, 1970". Noting that this breakdown in the Groups Advancing Index denoted a loss of momentum. I added, "But since it reflects a break in the upward momentum of groups advancing, it should be reflected in the A-D ratio or the number of issues advancing or declining daily. Currently, " I added, "we should see a tendency towards smaller pluralities of advances over declines on days when the Dow is rallying, and larger pluralities of declines over advances on days when the market declines. The second step should be a definite downturn in the A-D ratio, and the final step should be a reversal to the downside in the D-J Averages."

And that is just about what occurred. Note on the accompanying (daily) chart that during the whole February to April period, the momentum of the A-D ratio advance was flattening out despite the frenzied upward rush of the Dow Industrials. The two rates of ascent may be gauged by the trendlines marked A. Then during the latter part of April we received our first real danger signal when the A-D ratio on April 28, failed to better its April 19 peak. The Dow Industrials on April 28 closed at a peak of 950.82, while on April 19 it had closed at 948.85. This divergence is shown on the chart on the trendlines marked B.

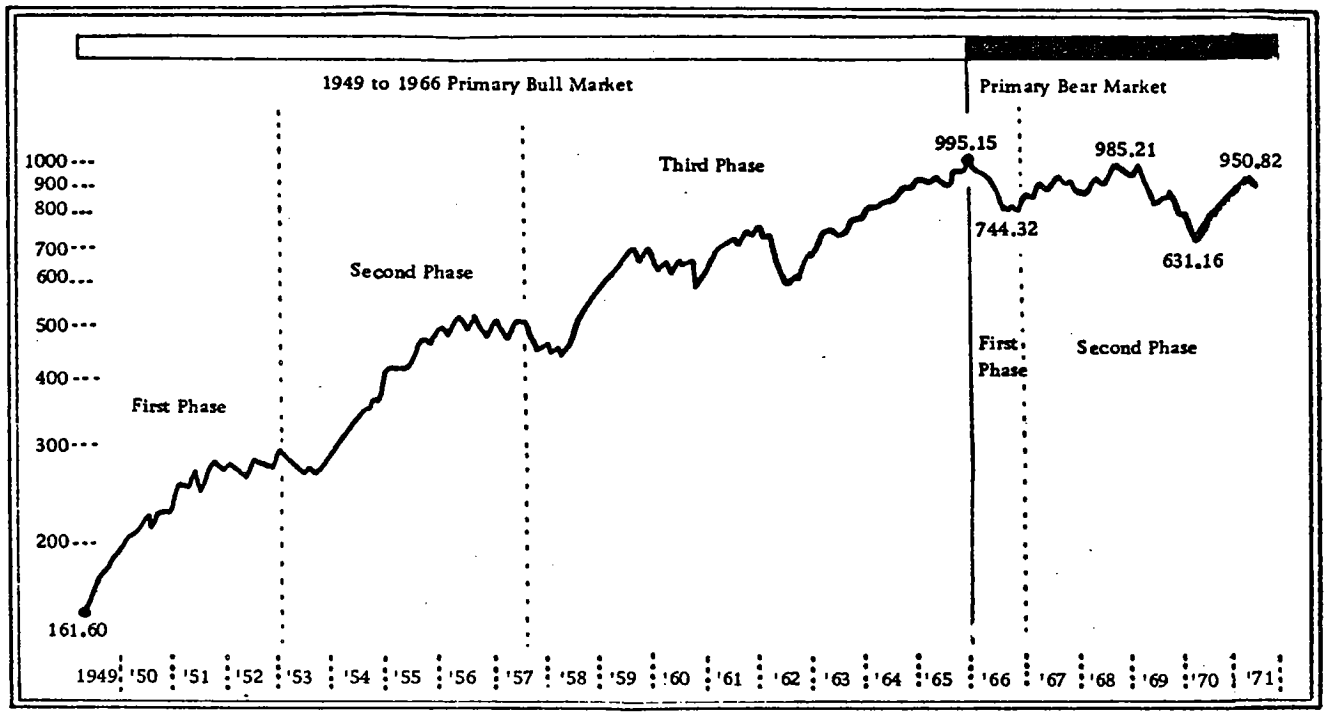
From there on, deterioration spread over the entire market with the Utility Average striking a new low for the year on April 30. On May 17 the A-D ratio broke below its February low, a low corresponding to the Dow February low of 868.98 (see chart).

On June 18 the A-D ratio plunged below its May low to its lowest level since January 11. On that date the Dow Industrials closed at 837.21, and this means that if the Dow is to confirm the A-D ratio on the downside, we could easily see the senior average sink to the 830-40 level over the near term. The action on June 18 also means that the A-D ratio has wiped out almost all of its gain for 1971 (hardly a happy performance, considering that the first six months of 1971 provided the greatest volume in N.Y.S.E. history). In other words, an awful lot of shares have been distributed.

PERSPECTIVE: On May 3 "The Professional Investor" (Lynatrace, Inc.) presented a full page on Dow Theory Letters (all within the context of a history of Dow Theory), and I am happy to say that they presented a very accurate and truthful view of my philosophy. A few excerpts from that article state, "He (Russell) feels that his studies deal with the long-term trend of the market as identified by Dow Theory signals". And later they say, "The important thing, Russell feels, is to be fully invested during bull markets and fully liquid during bear markets (except for gold shares)". Also stated is ".....it can be seen that the Dow Theory is not merely a mechanical method for reading the Averages. The Theory concerns itself with crowd psychology, volume of transactions, bull and bear market phases, degree of speculation, and all of these in relation to the action of the Averages themselves". So I say "Thank you" to Lynatrace, since it is seldom that I read anything having to do with Dow Theory which in any way even borders on the truth.

Speaking of Dow Theory, I feel that this may be a good time to present a long-term chart (page 3) of the D-J Industrial Average, covering the period of 1949 to 1966 (the primary bull market) and the period of 1966 to date (the primary bear market). It was Robert Rhea, the famous Dow Theorist of the 1930's who noted that a new primary bull market has little or no relationship with the bear market which preceded it. However, a primary bear market is related in extent and duration to the bull market which preceded it.

With this in mind, it is worth noting that the bull market of 1949-66 lasted a record 17 years, while advancing the Dow from 161 to 995. This 17-year advance amounted to a rise of about 520%, while adding 834 points to the price of the Dow. Since bear markets do tend to have a relationship with the preceding bull market (technically, a bear market is a major and full



correction of the preceding bull market), this may give us some hint as to what to expect before the current bear market breathes its last.

History shows us that the majority of bear markets tend to last from 1/3 to 1/2 as long as the preceding bull market while wiping at least half of the gains of the preceding bull market. If this bear market were to last 1/3 to 1/2 as long as the preceding 17-year bull market, we could expect termination around 1971 to 1974. If it were to wipe out at least half of the 834 points gained during the preceding bull market, we could expect the Dow to get down to at least 578, and perhaps much lower.

On the chart, I find it most interesting to note that each of the phases of the 1949-66 primary bull market was longer than the preceding. This is very atypical of bull markets, since classically the third or final phase of a bull market is much shorter than the second phase. I attribute the great 9-year third phase of the 1949-66 bull market to Governmental intervention and manipulation. This flagrant manipulation, particularly following 1962, succeeded in "building into the economy an edifice of fiat money, inflation, expansion of the money supply and production inefficiencies which must ultimately be fully corrected. Furthermore, even though the Dow Industrials recorded their bull market peak in February, 1966 (995.15), the Government attempted to manipulate and inflate at an even more furious rate after the primary bear market had started.

This had the effect of holding back the forces of the bear. Despite two powerful down-thrusts (1966, and 1968-70), frantic Government manipulations succeeded in bringing the Dow back to within 10 points of its 1966 high in 1968, and within 45 points of its 1966 high in 1971. Now a study of history suggests that the longer the primary trend is held back, the more powerful the ultimate expression of the main or primary trend.

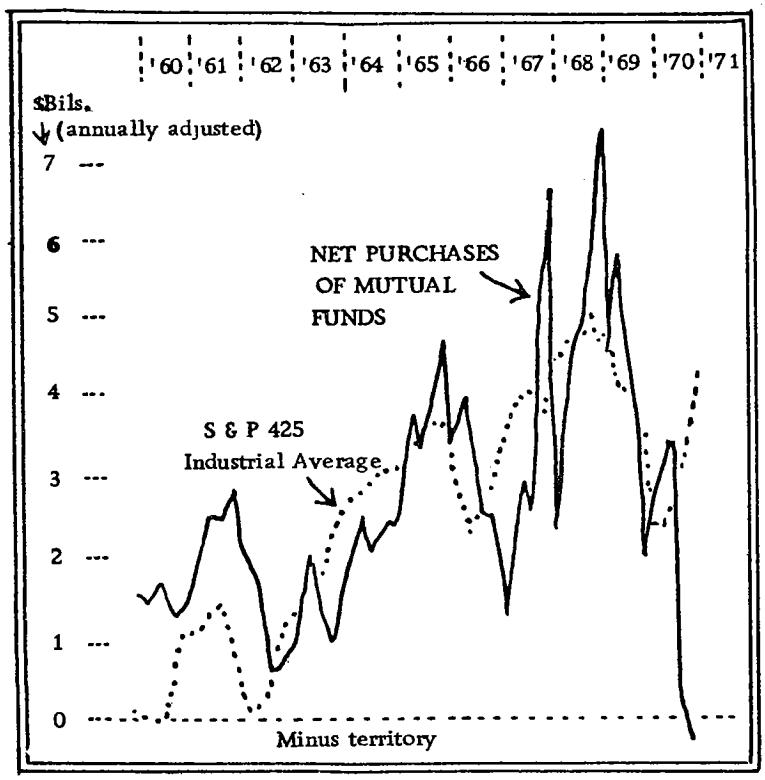
So here we are, five years after the 1966 bull market peak; the little investor has been hurt badly, many stocks are still far below their major highs, the funds and institutions are loaded with stocks, interest rates are climbing again, the economy is shaky, and the Dow is still within 120 points of its 1966 peak. My own guess is that we are now moving towards the "unraveling" and the major down-move which will wind up the second phase of this primary bear market. Remember, the second phase is classically the one in which stocks go down as they reflect the obvious deterioration in the economic, social and political fabric of the country. Classically, too, the second phase is the most deceptive phase, and certainly the period from late-1966 to date has been as deceptive as anyone could wish.

I would expect the finale of the second phase to smash the Dow below the 631 low of 1970, perhaps stopping in the 400 to 600 range. Then following a sub-standard rally (sub-standard because the first two rallies in this bear market were so far above standard), we should enter the third and final phase of the bear market. This will be the distress phase, the great liquidation stage, and it is here that the bad news, the shocking news, the disaster news will come out.

The third phase will also mark the beginning of the accumulation period for students of Dow Theory. For as the Dow plunges to extraordinary new lows, as many stocks sell for a fraction of their peak value, true Dow Theorists will begin their accumulation campaign, all at a time when it will probably look as if Wall Street will never recover again.

And so I will repeat that the great majority lose their money before a true primary bear market is over, and the great majority avoid the safest, the best and the most profitable period of a new primary bull market. In writing these reports I am attempting to reverse that process. I advocate staying liquid and out of a primary bear market (regardless of rallies, mouth-wateringly large or small), and staying fully invested in bull markets. Although there are many more investment tools available now than there were in Charles Dow's times, I doubt if he would disagree with me on any of the above.

EXODUS: Study the accompanying chart carefully. The black line shows the net purchases (i.e. purchases minus redemptions) in the mutual fund industry. According to data from the Federal Reserve Board, the first quarter of 1971 saw the funds net purchases dip to the minus side. In other words, funds lost money on balance when all redemptions were subtracted from all purchases. This is the first time this has occurred in the 30-year history of the funds.



Actually, it was the May figures which turned the tide, as it was announced that May redemptions surpassed purchases by $120 million. To make matters worse, the $55 billion mutual fund industry also announced that its cash position dropped to the $2.5 area, which meant that its cash position was an incredibly low 4.8% (it has not dropped below 5% since 1965). Thus it can be said that the funds are exceedingly low on cash and being subject (at least during May) to liquidation.

Now let's turn to the chart. The dotted line on the chart shows the path of Standard & Poor's broad 425 Industrial Average over the same period. Note that during the 1962 slide, net purchases held slightly above the zero line. Even during 1966, when the first phase of the bear market took the Dow from 995.15 to 744.32 in a period of eight months, the funds managed to gain in net purchasing power.

But the big second phase collapse of 1968-70 proved to be the turning point for the fund buyers and sellers. As the market moved up in a violent secondary reaction, the people who owned funds started to bail out. Perhaps it was the disastrous performance of the "Growth funds" during 1969-70 (they dropped 42% on average during that period) which frightened the public so badly. Perhaps it was the gradual but steady deterioration in business and the rising unemployment during 1970-71 which was responsible for the change in sentiment. At any rate, the fund industry and the market now face something new, and something I have been warning about for quite some time.

The real danger in the primary bear market, however, is the possibility of a long-term liquidation of funds by the public. Such a liquidation, particularly if it starts increasing to a $2 to $4 billion annual basis, could prove a dreadful scourge for Wall Street. E. George Schaefer, famed Dow Theorist from Indianapolis, feels that we may face as many as five years of net redemptions in the funds. I leave to your imagination what anything like that could mean on Wall Street and for the latent power of this primary bear market.

THE PICTURE: On June 18 the Wall Street Journal presented a lead column on a matter which I have been warning about for months, the specter of a trade war or as the Journal put it, "The U.S. Government is getting ready for a new cold war — against the rest of the free world". This is the picture which the Journal calls "the American nightmare", in which the other nations combine their lower wages and advanced technology and rout U.S. goods from both domestic and foreign markets. There is no questioning the fact that the U.S. faces many unfair and difficult trade laws, but the fact is also that they are there and they will not be easy to knock down.

As I see it, the trade war is now on, and it is going to get progressively more vicious as the European and Japanese economies slow down. In his June report, Alden Wells (Monetary Report) sees it from the monetary perspective and lays it on the line: "We have previously pointed out that the American market had absorbed all Europe's spare capital by mid-1970. Since no more was available a recession was inevitable. To this we can now add an ever increasing amount of capital directed towards speculation rather than production and trade. Changes or expected changes in currency prices create the trade war that suddenly our government worries about. The world-wide recession is now turning into a depression".

Even President Nixon's Chief economic Adviser, Paul McCracken, knows there is something amiss, and on June 17 he announced that the economy is moving too slowly and that the President in July or August will have to decide on new stimulants, such as a tax cut. This should be rather interesting, since stimulation at present is at the frenzied stage. I quote from the June 16 report prepared by the Federal Reserve Bank of St. Louis. "Growth of the money stock has accelerated at an 11.6% annual rate in the past five months, which is as great or greater than all other consecutive 5-month periods since World War II". Thus, the Fed has opened the valves wide, and it is most likely to start closing them from here on.

Imagine the consternation of our inflation-bent leaders as they now read that steel makers are closing plants because demand for steel is falling far short of expectations (and imports have soared) even as a possible steel strike is in the making. Imagine the head-scratching as unemployment rises in the face of the greatest inflation of the money supply in a quarter of a century. In his latest reports, economist Eliot Janeway points to the rising credit and collections troubles, and he notes that Uncle Sam is now in the scramble with money troubles of his own. "M.R.O." says Janeway, "tells the story of what's happening in America today: 'Money's Running Out'."

On top of all this, it seems that the whole Vietnam picture is blowing up in the face of the last four administrations. Perhaps a preview of what lies ahead occurred last week when the Delegates to the Wisconsin Democratic Convention voted to censure former President Johnson for "deceiving the American public in escalating the Vietnam War." I have written in many previous Letters that before this primary bear market is over, the truth will out on many fronts, and the dirty water which is seeping out from under the closet door will turn into a flood. Personally, I have read the first three installments of the New York Times Vietnam disclosures, and although I had always expected that it would read something like this when the truth finally emerged, I must admit that I was thoroughly disgusted. The idea of President Johnson running against Goldwater and berating the latter for his bomb-the-north policy, while at the same time President Johnson had his own plans for bombing the north, boggles the mind. The thought of high Administration policy makers discussing ways of sidetracking "premature" peace negotiations and figuring out ways to provoke North Vietnam into military action which would justify the U.S. escalating the war is hard for any decent person to take.

Two thousand years ago Jesus told the world, "Think not that I am come to send peace on earth: I come not to send peace, but a sword". That sword which he referred to was truth, and he was willing to swing the sword of faith and truth against any and all who denied it, even if it entailed pitting family against family and son against father. How would his insistence upon truth fare in today's climate? It's a thought calculated to curdle one's blood.

I mention the above in this stock market letter because while the Vietnam story and its gross duplicity is relatively "easy" to understand, the monetary and financial story is complex, difficult and almost impossible for the average citizen to understand. But in the end, the deception on the monetary and financial front (I believe) is fated to have severer repercussion than all the lies regarding the Asiatic war. But perhaps it's all of the same fabric, you can't build a great nation on an edifice of lies, and you can't build a great economy on a structure of greed and falsities. And evil on the part of your neighbor, it seems to me, does not justify one's own evil. All this will be seen as the bear market progresses.

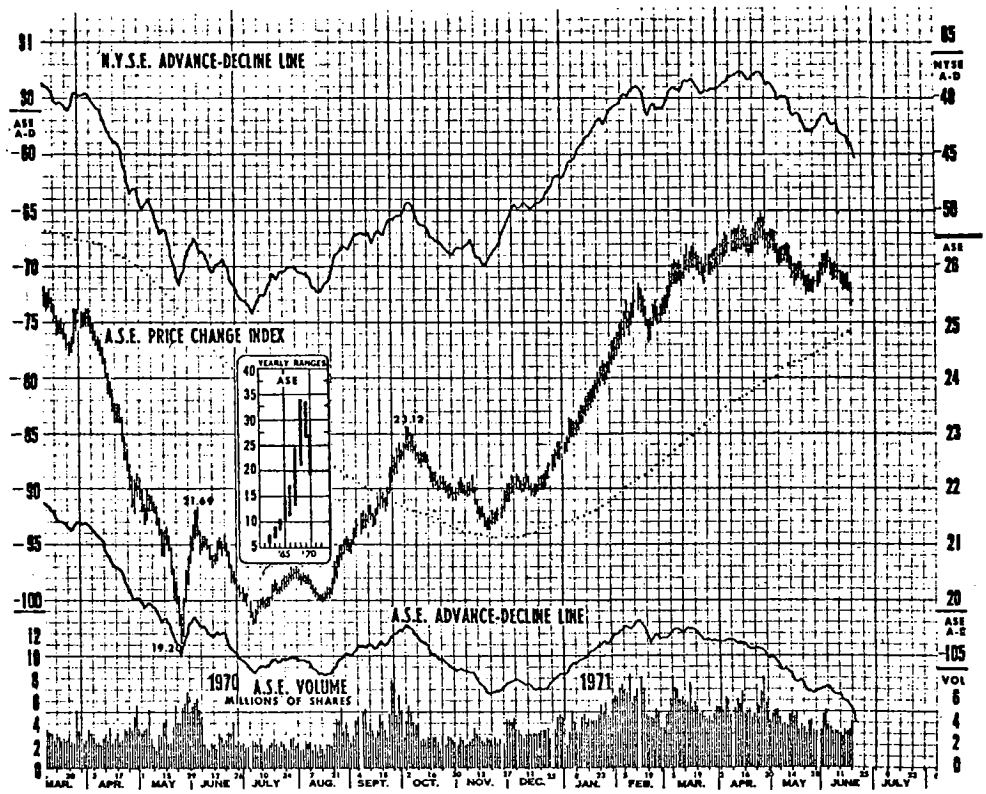
In the background the all important American consumer (and shareholder) is being stunned into the full realization of what he has been living through, what he has been doing with his life, what he has been listening to this last decade or so. And he likes it less and less. On June 22 a recent Congressional Medal of Honor winner stated that he was "stoned" on drugs during the action in which he held off two waves of Vietcong and so won the award. "God," I thought, "what are we doing to our own children?"

And what are we doing to ourselves? In past Letters I mentioned Arthur Okun's Consumer "Discomfort Index", which is simply the total of the rate rise in the Consumer Price Index and in the unemployment rate. I list the average yearly rates below, and I figure 1970's average rate at around 12%. Last week it was announced that the latest (May) rise in the Consumer Index was .6% or 7.2% per year, a whopping jump and one that throws the Administration's anti-inflation posture

Year	*Index*	*Year*	*Index*
1951	11.3%	1961	7.8%
1953	3.7%	1963	6.9%
1955	4.1%	1965	6.2%
1957	7.8%	1967	6.6%
1959	6.3%	1969	8.9%

into a cocked hat.

On top of the 7.2%, add the current 6.2% unemployment and this gives us a current reading of 13.4% for the Discomfort Index, the highest in generations. No wonder the American consumer is disgusted, bewildered and angry.



BATHTUB: In the last Letter I described my "bathtub principle", stating that during a primary bull trend the market acts like a bathtub which is gradually filling up, while during a primary bear trend the market acts like a bathtub which is slowly emptying.

There are a few signs already, despite the big 1970-71 rally, that the waterline in the market bathtub is slowly receding. For instance, I mentioned that the Utility Average touched a new low for the year last week, despite superior strength in the other Averages. Now I include a chart from Trendline (div. of Standard & Poor) showing that on the Amex, the advance-decline line (bottom line) has sunk to a new bear market low (actually below the 1970 low).

This indicates to me that since February, 1971, the stocks on the Amex have been under continuous and massive distribution, and that since October, 1970, the tendency has been for the majority of issues on the Amex to decline. What has occurred, I believe, is that the Funds have poured into the market, but this time (unlike 1967-68) they have bought up the blue-chips and higher quality issues. They were hurt so badly in the Amex issues during the smash of 1969-70 that they have been distributing ever since the first major rally which halted in late-1970.

It seems to be a foible of human nature that people always tend to avoid their most recent mistakes, while paying less attention to possible new mistakes which they are making in the present. Thus, I believe the funds are trying to avoid many of the speculative issues, while bidding the higher-grade issues up to prices that will not be sustained in the face of the economic stresses ahead. Let history be the judge.

ASIDE: I couldn't resist including this Berry cartoon, which seems to bear out a point I have been drawing attention to for many months. Drastic changes are occurring, and people's thinking is changing. For instance, the emphasis on status has been changing radically for years. One cannot pick up the paper, these days, without reading about some banker who has quit to take up painting or some businessman who has decided to chuck it all and take a cruise around the world on a home-made boat. The men's suit business has practically collapsed. Fewer and fewer men wear suits today, it's as simple as that.

I have long had a suspicion that all things financial start in the Eastern coastline of this nation and move West, all things social start on the West Coast of the U.S. and move East. One of the things which struck me when I first come to California 11 years ago (from N.Y.C.) was the lack of status. In the East, people asked you who your father is and what school you went to. In the West they asked you who you are, what you were doing today, and whether you liked what you were doing. In my opinion, the status collapse is good, but its economic implications will be painful. Regardless, I feel it is fated to sweep across the nation.

"What bothers me, is goin' inta town an' seein' all them young folks wearin' blue jeans an' overalls. I had NO IDEA there was so many farm hands outta work!"